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In this article, Kadet explains how the Tax Cuts and Jobs Act favors foreign-based manufacturers selling through a U.S. sales branch over comparable U.S. manufacturers, and he recommends legislative fixes.

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The Tax Cuts and Jobs Act (P.L. 115-97) amendment to the section 863(b) source rule provides an apparent competitive advantage to some foreign manufacturers over comparable U.S. manufacturers. This amendment benefits foreign-based manufacturers selling their products into the United States or selling them elsewhere in the world through U.S. sales branches. Moreover, this source rule is one more TCJA encouragement for U.S.-based manufacturers to offshore their manufacturing to lower their U.S. tax costs.[1] Exploring this matter also highlights ambiguity in applying the sourcing and effectively connected income rules to foreign manufacturers selling through a U.S. sales branch. After explaining these issues, recommendations are provided in this article that outline specific legislative fixes to eliminate the competitiveness issue, the encouragement to offshoring, and the ambiguity arising out of the new sourcing rule.

I. Background

Two recent *Tax Notes* articles have discussed the TCJA amendment to the section 863(b) source rule.[2] This amendment changed the source rule for sales and exchanges of inventory property produced wholly or partially by the taxpayer within one country and sold or exchanged in another country when one of the countries is the United States. The amendment provides that income from those transactions is sourced solely

[1] Many commentators have pointed out how the TCJA territorial taxation system, along with the reduced rate on global intangible low-taxed income, maintains the incentive that existed under the pre-TCJA tax rules to shift operations and profits outside the United States. *See* proposed regulations (REG-104390-18) issued September 13, 2018, for an explanation of congressional intent. In brief, recognizing the incentive that the new participation exemption (section 245A) gives to shift income into controlled foreign corporations, Congress had to reach a balance between its new tax base protection measures (GILTI, section 951A) and its goal of not harming the competitive position of U.S. corporations relative to their foreign peers (the section 250 deduction for a percentage of GILTI). This balance leaves the incentive in place. In particular, Martin A. Sullivan comments: "If GILTI doesn't discourage runaway plants that provide products and services to U.S. markets (for example, by denying the section 250 deduction to U.S.-derived eligible income), why are FDII benefits denied to products and services for U.S. markets? Or to phrase it in a more politically charged manner, why do U.S. tax rules favor foreign production over domestic production for goods and services provided to Americans?" *See* Sullivan, "What Economic Purpose Does FDII Serve?" *Tax Notes*, Oct. 15, 2018, p. 293.

[2] Jeffery M. Kadet and David L. Koontz, "Effects of the New Sourcing Rule: ECI and Profit Shifting," *Tax Notes*, May 21, 2018, p. 1119; Monica Gianni, "Inventory Sourcing Rules After the U.S. Tax Cuts and Jobs Act: Do the Changes Work?" *Tax Notes Int'l*, June 25, 2018, p. 1513.

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on the basis of the location of production activities regarding the property.

It is uncertain how this amendment to section 863(b) interacts with section 865(e)(2), which ostensibly overrides the new provision in some circumstances. Perhaps Congress, in its haste to enact the TCJA, missed this interaction and its implications regarding a competitive level playing field. Section 865(e)(2) causes otherwise-foreign-source income from the sale of personal property (including inventory property) to be U.S.-source when a nonresident maintains an office or other fixed place of business in the United States and the income is attributable to that office or other fixed place of business.

The conference report (H.R. Rep. No. 115-466) states in a straightforward manner, without acknowledging any potential conflict caused by the section 865(e)(2) override, that "income derived from inventory property sold in the United States, but produced entirely in another country, is sourced in that country even if title passage occurs in the United States."

While it is unclear what Congress intended, section 865(e)(2), as limited by section 864(c)(5)(C), remains unchanged and defines income from sales or exchanges of taxpayer-produced inventory as U.S.-source even though it would otherwise be foreign-source income under amended section 863(b). Focusing on this override, what it covers, and how its effect should be measured identifies a "competitiveness" issue that may benefit some foreign-based manufacturers and encourage U.S.-based manufacturers to move production overseas to gain the same benefits. Congress should address the competitiveness issue and provide a legislative fix that clarifies how sections 865(e)(2) and 864(c)(5)(C) interact with the new TCJA section 863(b) sourcing rule.

II. Fair Competition — An Unlevel Playing Field

When a taxpayer both manufactures and sells inventory within the United States, there will of course be full U.S. taxation and no generation of any foreign-source income. When a taxpayer sells its U.S.-manufactured inventory outside the United States (for example, title passes in a foreign country), newly amended section 863(b) causes 100 percent of the resulting income to be U.S.-source. This is true even if the taxpayer maintains a foreign sales branch and the sales are attributable to sales activities conducted within that branch.

Assume a taxpayer sells U.S.-manufactured products through a sales branch in Country A that constitutes a taxable presence in Country A, thereby causing the taxpayer to be subject to tax in Country A on a portion of its income. Because of the U.S.-source treatment now mandated by section 863(b), the taxpayer will be taxed on all its income, but will not be able to claim any foreign tax credit because no foreign-source income is generated by these sales. (See the limitation in section 904(a).) Thus, a part of this income is subject to double taxation. This double taxation result does not change, even if there is some amount of benefit from the TCJA's new foreign-derived intangible income regime (see section 250).

From the limited material in the committee reports accompanying the TCJA, it is unclear whether Congress intended this result (double taxation) or whether such a possibility was even considered, particularly taking into account that Congress has traditionally attempted to avoid double taxation through the FTC mechanism.

Although double taxation can result when a manufacturer sells its U.S.-manufactured products through a Country A sales branch, a Country A manufacturer selling into the United States through a U.S. sales branch could potentially have some amount of double nontaxation. Assume that under Country A's territorial tax system there is no tax imposed on the income attributable to a Country A manufacturer's U.S. sales branch. Double nontaxation will occur if the United States treats the manufacturer's income as all foreign-source under amended section 863(b) and if other applicable rules (for example, section 865(e)(2)) do not cause any portion of that income to be treated as ECI taxable in the United States. There is clearly an unlevel playing field.

This Country A manufacturer could, of course, be foreign-owned with no connection to the United States other than its U.S. sales branch. On the other hand, this manufacturer could also be a controlled foreign corporation that is a member of a U.S.-based multinational group or is

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otherwise owned by U.S. persons. If that CFC manufactured products outside the United States and sold them to U.S. customers through its U.S. sales branch, it would achieve the same double nontaxation (again assuming that no other applicable rule like section 865(e)(2) applies). Moreover, the group would receive the benefits of the section 245A participation exemption and the reduced effective tax rate on GILTI provided by the section 250 deduction. These are all powerful incentives to take real production and profits offshore.

III. Section 862(e)(2) Override

Although the new provision in section 863(b) states that all income is sourced to the site of production, section 865(e)(2) operates to override various source rules in sections 861-863. For sales of inventory by a foreign manufacturer that are attributable to a U.S. sales branch (assuming no material participation of an office or other fixed place of business outside the United States in relation to any sale of property that is sold for use, consumption, or disposition outside the United States), there are three possible outcomes. Before considering section 865(e)(2) and those outcomes, all income from those foreign-produced sales would be foreign-source, whether title passes inside or outside the United States. If title passes in the United States, section 863(b) expressly applies to make all income foreign-source. If title passes outside the United States, all income should be foreign-source because both manufacturing and title passage have occurred outside the United States.

Section 865(e)(2) applies to cause otherwise-foreign-source income from the sale of personal property (including inventory property) by a nonresident to be U.S.-source if the income from the sale is attributable to a U.S. office or other fixed place of business. This U.S.-source status is important because once a nonresident taxpayer is engaged in a trade or business within the United States,[3] that U.S.-source status will cause the taxpayer to have ECI under section 864(c)(3). As ECI, that income will be taxable at normal corporate rates (21 percent). Moreover, section 884 subjects the dividend equivalent amount to the 30 percent branch profits tax, except when an applicable tax treaty reduces the rate or eliminates this tax.

A discussion of the three approaches to applying sections 865(e)(2) and 864(c)(5)(C) to nonresident manufacturers follows.

A. No U.S.-Source Income From Override

Section 865(e)(2) is applied in accordance with the principles of section 864(c)(5), the relevant portion of which states:

> (C) the income, gain, or loss which shall be attributable to an office or other fixed place of business within the United States shall be the income, gain, or loss properly allocable thereto, but . . . the income which shall be treated as attributable to an office or other fixed place of business within the United States shall not exceed the income which would be derived from sources within the United States if the sale or exchange were made in the United States.

This subparagraph (C) places two important limitations on the section 865(e)(2) override.

First, the income attributable to the U.S. office or other fixed place of business is only that which is "properly allocable thereto." Legislative history[4] makes clear that this language was included to assure that income attributable to foreign production would not be included in the U.S. tax base.

Second, the income to be treated as U.S.-source under section 865(e)(2) cannot exceed the income that would be U.S.-source if the sale or exchange were made in the United States (that is, if the title passed in the United States). This

[3] There would be a trade or business within the United States because we are considering a taxpayer that has an office or other fixed place of business within the United States.

[4] *See* House report on the Foreign Investors Tax Act of 1966 (H.R. Rep. No. 89-1450, 1966-2 C.B. 967, at 16) and the Senate report (S. Rep. No. 89-1707, at 21). The former report says that "the amount of income attributable to the U.S. sales office is not to be more than would have been attributable to it if the sale had been made in this country. This gives assurance, for example, that the sales income attributable to a U.S. business will not include income properly attributable to manufacturing or any other activities (apart from sales) occurring outside the United States." The May 4, 1987, General Explanation of the Tax Reform Act of 1986 prepared by the Joint Committee on Taxation on page 922 confirms the continued applicability of these principles following the addition of section 865.

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limitation, therefore, is applied to a hypothetical situation.

The second limitation is applied to a Country A manufacturer's sales to all its customers (that is, whether title passes within or outside the United States) by applying amended section 863(b) to the hypothetical situation, which assumes that the sales have been made within the United States. Reg. section 1.864-6(c)(2) and (3), Example 1, make this clear.[5] With amended section 863(b) treating that income as sourced solely at the location of production, there is zero U.S.-source income from the section 865(e)(2) override.

Following the statutory language of sections 865(e)(2) and 864(c)(5)(C) to reach a nontaxable result for all the Country A manufacturer's sales seems strong. It is also consistent with the apparent intent of Congress to create fully foreign-source income when foreign-manufactured property is sold into the United States. Despite this "strength," there are two apparent issues.

First, there is a circular nature to this logic, especially for sales to U.S. customers, which goes as follows:

- section 863(b) provides for foreign-source treatment;
- section 865(e)(2) overrides section 863(b) to cause U.S.-source treatment;
- section 864(c)(5)(C) limits section 865(e)(2) by looking back to section 863(b); and
- section 863(b) provides for foreign-source treatment.

Second, legislators clearly identified the opportunity that foreign manufacturers had to sell through a U.S. sales office, and thereby use the United States as a tax haven. This was an important reason for the form that the ECI rules took in section 864(c) and later in the section 865(e)(2) source rule override. According to the October 11, 1966, Senate report (S. Rep. 89-1707, at 18):

> Your committee agrees with the House that foreign corporations carrying on substantial activities in the United States, in such cases, should not be able to cast their transactions in such a form as to avoid both all U.S. tax and most foreign taxes. Also, it is believed that foreign corporations should pay a U.S. tax on the income generated from U.S. business activities. There appears to be no national policy to be served by allowing foreign persons to operate in this country without paying their share of our governmental expenses.

When Congress enacted the TCJA amendment to section 863(b), it apparently did not consider that it might result in tax avoidance structuring by foreign manufacturers[6] or further motivate U.S. manufacturers to shift production and profits overseas.

B. Partial U.S.-Source Income From Override

Income that is U.S.-source under section 865(e)(2) is limited to that which is "properly allocable" to a foreign manufacturer's U.S. office or other fixed place of business (section 864(c)(5)(C)). This condition was meant to ensure that only income attributable to business activities within the United States would be taxed under the ECI rules. Although it can be viewed as a limitation on the application of the section 865(e)(2) override, it is also definitional guidance on what amount of income should be attributable to an office or other fixed place of business within the United States. Because of the circular nature of the statutory construction, there is perhaps some logic to applying the "properly allocable" condition in section 864(c)(5)(C) but not the additional limitation that hypothesizes the result if the sale or exchange were made in the United States.

As further support for the pre-TCJA congressional intent, the Senate report states (at 21):

[5] *See* reg. section 1.864-6(c)(2) and (3), Example 1. This regulation applies the section 864(c)(5)(C) limitation by expressly looking to the section 863(b) sourcing rules, including the "50/50 method" and other methods for apportioning income between production activities and sales activities that are described in reg. section 1.863-3(b). As noted in Section III.C, the various methods in reg. section 1.863-3(b) no longer have a statutory basis because of the TCJA section 863(b) amendment.

[6] *See* discussion of possible structuring in Kadet and Koontz, *supra* note 2.

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> The committee received considerable testimony requesting that the general foreign source effectively connected rules be modified so as to ensure in all cases that only income generated in the United States would be subject to U.S. tax. It is your committee's understanding that this was the intention of the House bill and, therefore, the addition of the 'properly allocable' test is considered to constitute a clarifying amendment.

With no apparent congressional intent to alter this "properly allocable" condition and the original intent to prevent the United States from being used as a tax haven, this approach could be arguable. If so, the IRS could apply the section 865(e)(2) override to relevant foreign taxpayers like the Country A manufacturer applying the "properly allocable" condition to determine ECI without applying the additional limitation that hypothesizes a sale or exchange made in the United States.

C. All U.S.-Source Income From Override

When section 865(e)(2) applies to a foreign manufacturer because of sales attributable to a U.S. sales branch, it clearly overrides both the section 863(b) foreign-source treatment (that is, inventory products manufactured outside the United States and sold within the United States) and the foreign-source treatment of foreign-manufactured product sales both manufactured and sold outside the United States. The section 863(b) amendment means there is no longer a statutory basis for the 50/50 method or the other methods in reg. section 1.863-3(b) for apportioning income between production activities and sales activities. This, as well as the circular nature of the relevant section 864(c)(5)(C) limitation, could provide an argument that whenever section 865(e)(2) applies to a sale, all the income from that sale should be treated as U.S.-source and therefore ECI. This is arguable because there is now no clear basis (other than the "properly allocable" test) to separate the foreign manufacturer's income into production and sales components, with only the latter being taxable.

IV. Needed: Level Playing Field & Clear Statute

The inconsistent statutory provisions and the ambiguous guidance in the TCJA conference report provide a roadmap for foreign manufacturers — including CFC manufacturers — to make sales of foreign-manufactured inventory property through a U.S. sales branch to avoid any U.S. taxation (as explained in Section III.A of this article). Often, foreign manufacturers would also avoid any home-country tax because of territorial taxation systems in their respective countries.[7] A comparable manufacturer conducting manufacturing within the United States would be fully taxable on sales both to U.S. customers and foreign customers, even when title passes outside the United States and the sales are attributable to a foreign sales office. Further, the manufacturer would receive no FTC on foreign taxes paid on those sales.

This result seems highly inappropriate and creates an unlevel playing field, with a Country A manufacturer holding a competitive advantage over any manufacturer that sells its U.S.-manufactured products to U.S. or foreign customers. It also adds significantly to the other TCJA provisions (the participation exemption and the GILTI deduction) that already motivate the offshoring of production and profits.

To ensure fair competition, discourage offshoring, avoid the use of the United States as a tax haven, and clarify the application of sections 865(e)(2) and 864(c)(5)(C), Congress should consider corrections that will accomplish the following:

- Make statutory changes that will give taxpayers manufacturing in the United States foreign-source treatment to the extent of income "properly allocable" to any foreign branch. This could be done by amending section 863(b) to provide an exception to this effect. The present rule in TCJA-amended section 863(b) would continue to apply to any U.S. manufacturer on its sales that are not attributable to an office or other fixed place of business of that

[7] *See* the discussion in Kadet and Koontz, *supra* note 2, regarding the potential use by foreign manufacturers of hybrid entities to conduct U.S. sales branch operations.

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taxpayer outside the United States. This change would prevent the current double taxation that can arise. To also prevent inappropriate cross-crediting of excess FTCs, a condition for this partial foreign-source treatment could be that some minimum amount of foreign tax (say, 10 percent) has been imposed. This would be consistent with the rules found in section 865(e)(1)(B) and (g)(2).

- Explicitly retain U.S. taxation under the section 864(c) ECI rules on the income of foreign manufacturers[8] that is attributable to their U.S. offices or other fixed places of business, applying the "properly allocable" standard. The easiest correction would be to apply the section 864(c)(5)(C) limitation to foreign manufacturers based on pre-TCJA source rules. A simplifying approach could be to make the 50/50 method in reg. section 1.863-3(b)(1) the sole approach for applying the "properly allocable" standard. ■

[8]Note that when a foreign person only purchases and resells inventory property (*i.e.*, the taxpayer does not itself manufacture what is being sold), section 863(b) will be inapplicable and the ECI tax rules will apply as intended by Congress to tax the relevant sales income. Thus, a foreign taxpayer will be free of any U.S. taxation on any such sales income if the taxpayer is not engaged in a trade or business within the United States. If so engaged and the sales are either U.S.-source based on the title passage rule or are attributable to an office or other fixed place of business within the United States, the taxpayer will generally be taxable on these sales. The exception allowing nontaxability will apply to any sale or exchange of inventory property that is sold for use, disposition, or consumption outside the United States when there is material participation in the sale by a foreign office or other fixed place of business of the taxpayer.

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